

**MINUTES
of the
SECOND MEETING
of the
INVESTMENTS AND PENSIONS OVERSIGHT COMMITTEE**

**July 10, 2013
Room 307, State Capitol
Santa Fe**

The second meeting of the Investments and Pensions Oversight Committee (IPOC) for the 2013 interim was called to order by Representative Jim R. Trujillo, chair, on Wednesday, July 10, 2013, at 9:10 a.m. in Room 322, State Capitol, Santa Fe, New Mexico.

Present

Rep. Jim R. Trujillo, Chair
Sen. George K. Munoz, Vice Chair
Sen. Jacob R. Candelaria
Rep. Larry A. Larrañaga
Sen. Steven P. Neville
Sen. Bill B. O'Neill
Rep. Jane E. Powdrell-Culbert
Rep. William "Bill" R. Rehm
Rep. Henry Kiki Saavedra
Sen. William P. Soules
Rep. Luciano "Lucky" Varela

Absent

Sen. Sue Wilson Beffort
Sen. Carroll H. Leavell

Advisory Members

Rep. Donald E. Bratton
Sen. Carlos R. Cisneros
Rep. Miguel P. Garcia
Rep. Roberto "Bobby" J. Gonzales
Sen. Stuart Ingle
Sen. Mary Kay Papen
Rep. Sheryl Williams Stapleton

Rep. William "Bill" J. Gray
Rep. Emily Kane
Sen. Timothy M. Keller
Rep. Tim D. Lewis
Rep. Patricia A. Lundstrom
Sen. William H. Payne
Sen. John C. Ryan
Sen. Michael S. Sanchez

Staff

Claudia Armijo, Staff Attorney, Legislative Council Service (LCS)
Amy Chavez-Romero, Assistant Director for Drafting Services, LCS
Pam Stokes, Staff Attorney, LCS

Guests

The guest list is in the meeting file.

Handouts

Handouts and other written testimony are in the meeting file.

Wednesday, July 10

Approval of Meeting Minutes

The committee, with no objections, approved the minutes from the IPOC meeting held on June 6, 2013.

Legislative Finance Committee (LFC) Overview of Asset Allocation Strategies and Investment Returns for the Public Employees Retirement Association (PERA), Educational Retirement Board (ERB) and State Investment Council (SIC)

Peter van Moorsel, economist, LFC, presented to the committee an overview of the general asset allocation strategies employed by the state's investment agencies, including the PERA, ERB and SIC. Mr. van Moorsel noted that the agencies' investment policies are shaped by their respective agency missions. For instance, the ERB and PERA manage pension funds, so their investment policies and target returns reflect obligations to their retirees. Alternatively, the SIC's investment policy and target returns reflect required annual distributions to fund beneficiaries.

Mr. van Moorsel indicated that asset allocation is an important component of the investment agencies' investment policies. Diversification of asset classes reduces risk in terms of return variability. The investment agencies generally conduct studies at least once every three years to determine whether their asset allocation strategies are consistent with the liabilities of the funds they manage.

The investment strategies of the agencies establish weights, benchmarks and ranges for the investment asset classes. The ERB and PERA require asset allocation plans expected to achieve an assumed overall rate of return on fund investments of 7.75 percent. The SIC's benchmark is 7.5 percent.

Mr. van Moorsel described the asset allocation targets adopted by the investment agencies. He stated that the PERA's policy requires the greatest investment in domestic and foreign equities, at 49 percent, while the ERB's policy requires the least exposure to equities, at 37 percent. Mr. van Moorsel pointed out that because the agencies have different strategies and different asset allocations, their policies include different benchmarks.

According to Mr. van Moorsel, an appropriate measurement of a policy allocation benchmark is comparison to a defined peer group. Mr. van Moorsel compared the funds' policy indices to the Wilshire Trust Universe Comparison Service median fund actual return. He said that the PERA's policy allocation returned 1.24 percent less than the median fund, while the SIC's policy allocation returned .02 percent below the median fund, and the ERB's policy allocation returned 1.52 percent below the median fund.

Mr. van Moorsel described how investment agencies might attempt to maximize investment returns through indexing or asset management. He noted that while investment gains through asset management are not usual with respect to assets such as equities and fixed income assets, high potential for such investment gains exists with respect to opportunistic credit and private equity asset classes. External manager fees, Mr. van Moorsel stated, are a cost of asset management. External fees could be reported on-budget or off-budget, dependent upon the asset class.

Committee members discussed with Mr. van Moorsel various issues, including:

- the reasons for the return-on-investment benchmarks adopted by the investment agencies and the previous need to make those benchmarks more attainable;
- the status of the investment funds' post-recession recovery;
- a recent external, comparative study of the rates of return of various pension funds throughout the country;
- the reasons for cash balance requirements for investment agencies, such as the ERB, including liquidity for payroll purposes;
- how the rate-of-return benchmarks help shape the agencies' investment policies and the agencies' distributions to beneficiaries;
- the necessity for distribution of information regarding the manner in which money flows to and from the state's investment funds;
- a comparison of asset management fees among the state's three investment agencies; and
- the rates of return for individual investment asset classes.

PERA Recent Investment Performance and Strategy to Meet Long-Term Earnings Benchmark; On-Budget and Off-Budget Asset Management Fees

Joelle Mevi, chief investment officer, PERA, provided the committee with an overview of the PERA's investment strategy and the management fees paid to investment managers. Ms. Mevi began her presentation with a comparison, since inception and over the last 15 years, of the actual rate of return earned by the PERA fund to the PERA board's established target rate of return and its long-term benchmark. Ms. Mevi indicated that, overall, the performance of the fund has been exceeding its targets and benchmarks. She stated that the PERA fund has grown from \$11.7 billion on June 30, 2012 to \$13.268 billion on May 31, 2013.

Ms. Mevi attributed the fund's overall performance to the PERA's investment strategy, focused on asset allocation and investment in equities. She indicated that over the last fiscal

year, the PERA's equity allocation has increased due to the strength in the global equity markets. She also attributed the fund's performance to the value added by investment managers.

Ms. Mevi indicated that the PERA board has recently adopted a re-balancing policy that sets ranges for its asset allocation target percentages. For example, the target for international equity has been reduced from 27 percent to 20 percent while increasing the target for real assets. She also commented on the PERA's cash balances, indicating that the PERA keeps a one percent cash balance in order to meet liquidity demands, including payroll. She estimated that the cash balances range from \$85 million to \$100 million.

Next, Ms. Mevi focused her discussion on the PERA's policy on management fees. She emphasized that the PERA's investment policy broadly focuses on administering the investments of the PERA at a reasonable cost while avoiding diminishing quality. Using preliminary figures for June 13, Ms. Mevi estimated that the PERA paid approximately \$64.7 million in asset manager fees. About \$22.7 million were paid with respect to management of traditional assets, such as stocks and bonds. Those fees are budgeted by the Department of Finance and Administration. In addition, about \$28.6 million in management fees were paid with respect to investments in hedge funds, and \$13.3 million were paid with respect to investments in private assets. Overall, management fees constituted approximately one-half percent of the total fund market value.

Committee members discussed with Ms. Mevi several issues, including:

- the reasons for the reduction of the PERA's target rate of return from eight percent to 7.75 percent, including improved attainability;
- comparison of the PERA's management fees to those of the ERB and SIC;
- the amount of cash balances kept by the PERA to meet liquidity needs, such as refund payment;
- the methods by which management fees are paid by and reported to the PERA;
- the manner in which the value added by external managers is distinguished from market performance, including the use of consultants to make such distinctions;
- a recommendation to compare the performance of the PERA's external managers relative to other external managers;
- the amount of discretion provided to the PERA's external managers within the guidelines set by the PERA board;
- the necessity for implementation of "stop-loss" strategies and the PERA's inquiry of potential asset managers about such strategies;

- reasons that some benchmarks for asset managers are not adjusted, such as negotiated contracts; and
- the minimum and maximum fees that can be earned by the PERA's external investment managers.

ERB Recent Investment Performance and Strategy to Meet Long-Term Earnings Benchmark; On-Budget and Off-Budget Asset Management Fees

Bob Jacksha, chief investment officer, ERB, provided the committee with an overview of the ERB's investment performance, strategy and the management fees paid to investment managers. Mr. Jacksha highlighted that, on March 31, the Educational Retirement Fund balance reached an all-time high of \$10.2 billion. Investment earnings for the 12 months ended March 31 exceeded \$950 million, a return of more than 10 percent. Portfolio returns equaled or exceeded actuarial targets in most measured periods, and actual returns exceeded the policy index in all measured periods. Mr. Jacksha noted that the comparison of the Educational Retirement Fund's actual earnings to the policy index reflects the value added by the ERB's investment managers.

Mr. Jacksha indicated that the fund continued to enjoy positive investment performance in April and May. On May 31, fund assets approximated \$10.3 billion. While returns for June are expected to reflect about a two percent reduction, the final determination of fund assets for the end of the fiscal year will likely still exceed \$10 billion.

The ERB's investment strategy, according to Mr. Jacksha, is motivated by the necessity to meet its basic pension equilibrium formula. The formula requires that contributions to the Educational Retirement Fund from employees and employers, plus investment returns, equal benefits paid and the fund's expenses. In the ERB's case, it has determined that to satisfy the formula, investment returns must equal at least 7.75 percent.

A second goal implicit in the ERB's investment strategy is to reduce return volatility through diversification. Mr. Jacksha stated that the ERB uses asset allocation to accomplish diversification. He said that asset allocation is the primary determinant of the ERB's investment returns.

Components of the ERB's investment strategy include determinations of the possible returns relative to market indices (alpha) and managerial skill (beta), and whether to use active or passive asset management for the various asset classes. The ERB must also determine whether to use external or internal managers.

Mr. Jacksha provided an analysis of various asset classes, their expected rates of return and their expected volatility. He indicated that as part of its investment strategy, the ERB determines how the individual asset classes move relative to other asset classes in a given economic or market cycle. Assets for which returns move in opposite directions generate a

portfolio with less risk. Mr. Jacksha explained that the ERB compiles a matrix of the forecasted asset class correlations. The matrix is used to generate an optimal asset allocation. The ERB's actual asset allocation as of March 31, 2012 is expected to generate a return of 8.2 percent over the next 30 years.

Mr. Jacksha discussed the management fees paid by the ERB. The ERB looks to the two sources of return for a portfolio, beta and alpha. He explained that higher management fees are characteristic of markets with a higher alpha, derived from manager skill. In markets with little to no alpha, the ERB seeks to minimize managerial fees. For instance, in large cap U.S. equity markets, international developed equity markets and core fixed income markets, market fees are relatively low because those markets are characterized by low alpha potential. On the other hand, in opportunistic credit and private markets, characterized by high alpha potential, managerial fees are high. Mr. Jacksha described, in detail, the process by which managerial fees are paid with respect to various markets, including the profit-sharing component of fees paid with respect to private markets. In fiscal year 2012, the ERB paid approximately \$78.7 million in total investment management and consulting fees, including both off-budget and on-budget expenses. Total on-budget expenses approximated \$14 million, while off-budget expenses approximated \$64.7 million.

Mr. Jacksha summarized the ERB's goals when it invests in various asset classes. With respect to private equity, he explained that the ERB aims to achieve a long-term net return in excess of public equities, with the secondary goal of gaining some portfolio diversification benefits. With respect to opportunistic credit assets, including high-yield bonds and foreign bonds among other assets, the ERB seeks additional portfolio diversification, while generating attractive returns that will lag public equities during bull markets. For global tactical asset allocation assets, the ERB seeks additional portfolio diversification and reasonably attractive net returns over time.

Mr. Jacksha provided a listing of the performance of its investments in various asset categories. In the context of a discussion of the benefit of the ERB's use of external managers, Mr. Jacksha opined that it is reasonable to conclude that the ERB reached more mature funds and outperformed the public markets. Finally, Mr. Jacksha highlighted that all of the ERB's alternative assets are reported net of fees and that all of the fees charged by the ERB's traditional managers are reported gross of fees.

Committee members discussed with Mr. Jacksha the following issues, including:

- the manner in which performance fees for investment managers are set;
- the relative aggressiveness of the various individual asset classes;
- the possible necessity for a "stop-loss" strategy for the ERB;
- the effects of time and performance on management fees; and

- the circumstances under which investment management contracts may be terminated and the effect upon the investment manager to continue to get paid pursuant to applicable profit-sharing provisions in the contracts.

PERA Board Travel, PERA Overview and Status of the Legislative Retirement Plans

Wayne Propst, executive director, PERA, provided the committee with information regarding the PERA board members' expenditures for travel. He noted that at the end of fiscal year 2013, the PERA will revert 14 percent of its appropriation allocated to board travel and training. Mr. Propst indicated that such travel and training expenditures are necessary because board members are statutorily required to complete eight hours of training per year. He stated that some of the most informative training sessions occur in other states and require travel.

Ultimately, Mr. Propst indicated that the PERA board members are cognizant of the need to be prudent in expending trust fund money for travel. He further stated that the PERA board is not unique in its participation in "due diligence" site visits and that such visits have been identified as comporting with best practices. Mr. Propst indicated that such travel constitutes a minimal expenditure relative to the PERA trust fund balance.

Patricia French, chair, PERA board, discussed the necessity for board travel. She emphasized that travel for due diligence trips and training is necessary for board members to meet their fiduciary responsibilities to the PERA beneficiaries. The committee members discussed with Mr. Propst and Ms. French the goal of balancing prudent spending with the necessity for adequate training, acknowledging the magnitude of the pension funds that the board members oversee.

Mr. Propst next highlighted a number of statistics pertaining to the Legislative Retirement Fund. He noted that its "funded ratio" is 92 percent, with 101 total active members and 163 retirees. He also stated that the average age at retirement is 65.8 years.

Mr. Propst explained that a cost-of-living adjustment (COLA) will apply to legislative retirement plan members as a result of this year's passage of Senate Bill 27. The bill reduces the compounding COLA from three to two percent, with no change in eligibility for employers who retire at age 65 years or older due to disability. The period for COLA eligibility is also extended to seven years from two calendar years, with a graduated eligibility period for active members retiring between July 1, 2014 and July 1, 2016.

Mr. Propst discussed in detail the manner in which annual pension benefits are calculated. Under plan 2, the annual pension benefit for retirees is calculated by multiplying 11 percent of the per diem rate in effect on the first day of the calendar year the member retires by 60 and the applicable service credit. He stated that the Legislative Retirement Fund was created in the State Treasury to finance the benefits under state legislator plan 2. The state contributes an amount necessary to finance the benefits provided under plan 2 on an actuarial reserve basis.

Finally, Mr. Propst described the funding mechanism for the Legislative Retirement Fund. He explained that the Oil and Gas Proceeds and Pass-Through Entity Withholding Tax Act requires withholding on: (1) all payments of oil and gas proceeds derived from wells located in New Mexico, except for payments to individual residents of New Mexico or tax-exempt entities; and (2) distributions to nonresident owners of profits not subject to oil and gas proceeds withholding provisions from pass-through entities that do business in New Mexico. From the withheld amounts paid to the Taxation and Revenue Department, it makes an automatic monthly distribution of \$200,000 to the fund.

Committee members subsequently discussed issues pertaining to the provision of pensions to legislators who retire at a young age.

SIC Recent Investment Performance and Strategy to Meet Long-Term Earnings Benchmark; On-Budget and Off-Budget Asset Management Fees, Including Alternative Asset Fees

Steven Moise, state investment officer, SIC, and Vince Smith, deputy state investment officer, SIC, provided the committee with an overview of the SIC's investment performance and strategy and the management fees paid to investment managers.

Mr. Moise indicated that, according to preliminary June 30 data, the SIC manages \$17.013 billion in assets, including, among other funds, the Land Grant Permanent Funds (LGPF) and the Severance Tax Permanent Fund (STPF). The estimated value of the LGPF is \$12.024 billion, while the estimated value of the STPF is \$4.124 billion. Mr. Moise noted that the value of the STPF has dropped by approximately \$600 million from its highest value in 2007. He highlighted that transfers from the Severance Tax Bonding Fund to the STPF dropped significantly, to \$85.00, in the 2013 calendar year. Mr. Moise suggested that sources for contributions to the STPF should be explored.

Mr. Smith discussed the SIC's long-term return targets and its investment strategy. He noted that asset allocation is a key component of the SIC's investment strategy. In 2011, the SIC conducted an asset allocation study with assistance from advisors. As a result of its review of its portfolio target and risk level, the SIC ultimately determined that its return-on-investment target of 8.5 percent should be reduced to 7.5 percent.

In keeping with its goal to reduce risk and volatility, the SIC has focused its strategy on shifting focus away from public equity risk and diversifying its investments. In particular, Mr. Smith indicated that the SIC is concerned with increasing exposure to income-producing investments that protect purchasing power and increasing investments that perform favorably when interest rates rise. Such investments could include floating rate debt, timber and energy. Mr. Smith mentioned that in an economic climate characterized by rising interest rates and slowed gross domestic product growth, real assets tend to perform more favorably relative to other asset classes. Mr. Smith also provided the SIC with a detailed graph pertaining to the SIC's asset allocation history and a table summarizing the results of its asset allocation study.

Mr. Smith next spoke about the impact of its asset allocation study on the investment management fees it pays. He stated that investment strategy determines the fee structure for SIC. He noted that some asset classes are better aligned with passive management, while other asset classes perform more favorably with active managers. Keeping this in mind, Mr. Smith stated that the SIC will consider the best-in-class managers charging a market rate and will negotiate fees. Economies of scale with respect to larger funds are also considered. However, Mr. Smith noted that management fees are not viewed by the SIC as merely an expense that should be minimized. The SIC ultimately attempts to pay fees that will attract quality managers who will yield the best returns for the state.

Mr. Smith explained that with respect to investments in publicly traded stocks and bonds, management fees are generally based on total assets. Those fees are paid through the budget process. With respect to alternative investments, Mr. Smith said that management fees are typically "embedded" with the managed assets. The management fees for alternative investments vary with the asset class. When discussing the various management fee structures, Mr. Smith noted that, in most cases, the return on investment resulting from the value added by managers exceeds the management fees paid by the SIC. Overall, the return on investment is expected to be about \$2.00 to \$3.00 for every additional \$1.00 paid in fees. Still, Mr. Smith added, the SIC always attempts to negotiate lower management fees.

Mr. Smith provided a general comparison of SIC management fees to the management fees paid by the state's other investing agencies. Mr. Smith said that, like the other agencies, the SIC pays management fees that are at or below the market rate. Mr. Moise added that it is often difficult to draw specific comparisons between the management fees paid by the different agencies within the state or among similar agencies nationwide because of the differences among the agencies' asset allocations.

Committee members discussed with Mr. Moise and Mr. Smith the following topics:

- the size of the funds managed by the SIC relative to those managed by similar agencies in other states;
- the manner in which management fees are budgeted;
- the impact of capital outlay needs on the STPF;
- the possibility of seeking sources of sustainable funding for the STPF, in addition to or in replacement of severance tax revenues; and
- the expectations for continued growth of the LGPF.

Adjourn

There being no further business, the committee adjourned at 3:15 p.m.